

Hydro One Network Inc.'s Responses to Ontario Energy Board Questions Respecting the Cost of Capital (EB-2006-0088) and the 2nd Generation Incentive Regulation Mechanism (EB-2006-0089)

Hydro One Networks Inc. ("Hydro One") responses to the Ontario Energy Board's ("the Board") questions are provided below.

1. COST OF CAPITAL

Question 1

Should the Board move off its current cost of capital methodology for determining capital structure, ROE, and debt rates (i.e., the current method as detailed in the 2006 Handbook)? If so, what are the reasons for the Board to do so? If not, what may be the implications, if any, of the Board staying with the current approach? Are there any elements in particular that you believe should change (i.e., capital structure, approach to updating ROE, debt rates, other)?

Hydro One Response

The determination of the appropriate capital structure and associated return on equity and debt rates for Ontario's electricity utilities is a significant component of their respective revenue requirements. As such, any move away from established practices of the Board must not be made in haste without a thorough review of the implications and impacts of such a move.

Hydro One believes that for utilities with third party debt outstanding, it is imperative that the capital structures for these utilities be initially established in a full cost of service review proceeding where evidence of all stakeholders can be thoroughly tested. The capital structure should follow the stand alone principle, be reflective of each utility's specific business risks and provide for the maintenance of creditworthiness and financial integrity. This was how Hydro One's initial capital structure was established.

For these utilities long-term debt rates should reflect the actual cost of each debt issue and the forecast cost for debt instruments not yet issued. The cost rate for utilities with preference shares outstanding should be the actual/forecast coupon rate of the actual/forecast preference issue.

Awarded equity returns for these utilities must meet both the standards of attraction of capital on reasonable terms and conditions and comparable returns and should reflect consideration of multiple test results and the unique risks faced by each applicant.

Once the equity return has been established, Hydro One supports the annual update of each utilities' ROE using the existing automatic adjustment formula as initially

formulated incorporating adjustments to both the risk free rate and the risk premium. It should be noted that the 2006 Distribution Rate Handbook did not incorporate the latter adjustment correctly. This methodology is used by the Board in its regulation of the natural gas utilities in Ontario and is consistent with the update mechanisms used by many other Canadian regulators.

If Hydro One were before the Board for a full distribution cost of service review, the appropriate capital structure the Company would be seeking would include a 40 per cent common equity component with an additional preference equity component of up to 4 per cent with a requested equity return of 10.5 per cent as noted in Ms. McShane's submissions.

Question 2

The current approach provides for four different deemed capital structures based on the size of the distribution company. What are the advantages and disadvantages to maintaining differentiation? Many parties maintain that distributor size is the best proxy for business risk. Are the business risks for large and small distributors converging or diverging in recent years, and is any trend likely to continue in the future?

Hydro One Response

For utilities that do not have third party debt outstanding, the Board may wish to continue the practice of differentiating risk through the establishment of different deemed capital structures as size is still a relevant proxy for the differences in risk. The Board may wish to consider the adoption of two tiers for these utilities based upon a rate base size threshold. Utilities with a rate base of less than \$100 million could be allowed an equity component of 50 per cent and those greater than \$100 million an equity component of 40 per cent.

The advantage to maintaining the above differentiation is that it recognizes that the risks are not the same, and that a smaller utility on a stand-alone basis would be viewed as higher risk by investors. If the Board is going to apply deemed debt rates to the small utilities that assume they are investment grade, then a capital structure that would notionally be compatible with investment grade debt is appropriate.

Neither Hydro One nor Foster Associates Inc. have studied the issue of risk convergence or risk divergence.

Question 3

Should the Board provide incentives for new infrastructure investment within the cost of capital methodology? If so, how might the Board do this?

Hydro One Response

Utilities are facing the need for unprecedented levels of capital infrastructure investment to meet improved reliability and new generation supply mix needs. To facilitate these capital requirements the Board should give consideration to more than one mechanism to provide utilities with the necessary incentives to make the necessary capital investments.

In our August 14, 2006 submission we suggested the Board give consideration to the inclusion of a trigger mechanism for the application of an incentive return. Another mechanism is the proposed adjustment for capital discussed in response to Question 1 under the Incentive Regulation section of this response. A third mechanism would be the inclusion in rate base of capital as spent for larger distribution infrastructure projects.

Question 4

What are the implications, if any, if distributors relied solely on long-term debt to finance their businesses?

Hydro One Response

The only way a utility would be able to finance with 100% debt would be if the debt were guaranteed by a third party, who would then be bearing the business and financial risk of the utility. The guarantor is entitled to compensation reflecting the stand-alone risks of the utility. A return on rate base comprised of a deemed capital structure consistent with the utility's stand alone business risks, and a cost of debt and equity also reflecting the stand-alone risks, would represent reasonable compensation for the risks borne by the guarantor.

Question 5

Should the Board rely on one method for determining the ROE, or should it use a variety of statistical methods? Which method or methods are the most appropriate and why?

Hydro One Response

Hydro One believes that the Board should use multiple tests in determining a fair return. Ms. McShane's presentation to the Board, which has been filed along with the Hydro One's responses to the Board's specific questions, addresses the rationale for using more than one method, and the strengths and challenges of each method.

Question 6

Is there any information from the Canadian financial community that there is a liquidity crisis and that major lenders such as the banks cannot loan money to electricity distributors for capital projects?

Hydro One Response

The real issue that the Board needs to be concerned about is not whether there is today or in the future a liquidity crisis, but whether for a given capital structure and equity return level, will utilities be able to access the long term debt market at reasonable rates. There is every indication from the Canadian financial community that adoption of the Board staff proposal could have financial consequences for Ontario's electric utilities. Negative concerns have been expressed by:

- Bank of Montreal report filed by Enersource with the Board on July 5, 2006;
- Bank of Montreal report dated August 8, 2006 entitled "OEB Staff Proposals Could Freeze Capital out of Ontario LDCs";
- Moody's Investment Service – Credit Opinion: Hydro One Inc., dated August 28, 2006;
- Standard and Poor's Industry Report Card dated July 27, 2006; and
- Dominion Bond Rating Service – Hydro One Credit Rating Report, dated June 30, 2006.

Question 7

Should the Board impose dividend restrictions if higher ROEs are argued to be needed to attract capital financing? If there is a higher ROE, should the increased revenues be used to finance capital projects from internally generated funds and not be given to pay management bonuses and higher dividends.

Hydro One Response

Hydro One has concerns with the notion of imposing dividend restrictions. The return on equity represents compensation to the equity shareholder for assuming both business and financial risks, where the financial risks are reflected in the capital structure ratios that are deemed by the Board. In that context, the LDCs should be expected to maintain an actual capital structure that reasonably mirrors the capital structure deemed for regulatory purposes. Dividend payments represent one means of managing the actual capital structure to the ratios prescribed by the Board. In Hydro One's view, the Board should monitor the actual capital structures of the LDCs to ensure that they are either maintaining actual structures consistent with the deemed structures or, if the actual equity has not reached the deemed level, that the LDCs are retaining sufficient earnings to be able to equate the actual and deemed levels over a reasonable period of time.

Question 8

What, if any, concerns would there be if implementation in Cost of Capital changes were delayed until 2008? This would relate specifically to the K-factor in the IRM price cap formula for 2007, which is intended to proxy the changes in the revenue requirement and rates that would result from adjusting the allowed ROE.

Hydro One Response

Hydro One sees no reason to delay the implementation of the Cost of Capital changes to 2008 as discussed in response to Question 3 under the Incentive Regulation section. The existing adjustment mechanism for ROE should continue to be used, incorporating the 75 basis point adjustment and should continue to be predicated on the benchmark return that was initially adopted.

Question 9

Are there any implementation issues that have not been addressed?

Hydro One Response

Please refer to Hydro One's response to Question 5 under the Incentive Regulation section.

2. Incentive Regulation Mechanism

Question 1

There are different views on what elements are important to a successful IR mechanism, even if it is transitional. What elements, if any, do you believe are of particular importance to 2nd Generation IRM (i.e., price escalator, X-factor, Z-factors, off-ramps, earnings sharing, service quality, other)?

Hydro One Response

Hydro One generally agrees with the elements of the IR mechanism that have been proposed for 2nd Generation IRM. The elements included are generally consistent with the prevailing incentive adjustment models used in other jurisdictions.

The 2nd Generation IRM model is relatively simple and reflects the need to adopt workable adjustment mechanisms for the interim period that are not based on factors derived from extensive studies, or that are based on substantial data gathered from the regulated LDCs. Therefore, the elements that are included in the model offer a

rudimentary approach to support mechanical adjustments for setting rates during the 2nd Generation IRM plan period.

Having said that, Hydro One is concerned that the proposed model does not account for potential growth in rate base or capital costs that LDCs are likely to experience during the incentive plan period. Hydro One has previously noted in its written comments to the draft proposals that incremental capital expenditures are likely because of the need to maintain the reliability of services provided with an aging distribution infrastructure, and because costs will result from implementation of Government directives with respect to new generation supply mix. Without having suitable adjustment mechanisms to address this issue, the potential exists for LDCs to not do much needed capital investments and rather wait until rebasing of distribution rates. The risk of deferring cost recovery to later period is increased, particularly if the costs to be incurred during the period are substantial.

The Board's Staff proposal to reinstate SQI and performance measurement tracking indicates that there is an expectation that maintaining reliability and quality of supply are important issues that the Board wants to address during the interim period. Therefore, it seems logical that some allowance needs to be made in the incentive model to allow for the recovery of capital costs that are expended for the very purpose for which the Board wants the LDCs to report on performance.

Question 2

What empirical approaches might be considered to determine an appropriate X-factor, either in common for distribution companies or segmented into groups? What reasons can be provided to include a stretch factor?

Hydro One Response

As it stands the choice of a common X-factor to be applied for all distributors is probably the best that can be done in the allowed time prior to the implementation of the 2nd Generation IRM. Hydro One would recommend staying with the proposed value for the duration of the 2nd generation IRM. At this time there is probably little to be gained from introducing stretch factors since there is little or no understanding of the relative standing of the LDCs with respect to their cost efficiencies and/or productivity targets. Consequently the Board has little or no indication as to what it should be aiming for in terms of achieving a target by the end of the 2nd generation IRM.

However, looking forward to the 3rd generation IRM there will be a need to determine a more appropriate X-factor that is more reflective of status of the distribution industry in Ontario and that accounts for the differences in LDCs. In this respect it would be more appropriate for the OEB to undertake a study to determine the preferred approach. All of the LDCs should be required to provide supporting evidence of cost efficiencies (historical and forecast) to help establish the status of efficiency gains by the LDCs and

to develop the thresholds that would help group LDCs for the purpose of setting representative X-factors.

Also, it would be beneficial to start to gather information on processes and approaches used to set the adjustment mechanisms from those jurisdictions where incentive regulation is well established, and where it has shown benefits to the regulator, the regulated utilities and the electricity consumers.

Question 3

If the cost of capital is adjusted prior to the rebasing of distribution rates, should a mechanism be created to make interim adjustments to rates? If so, what mechanism might be appropriate? Are there any implications to not making interim adjustments?

Hydro One's Response

The effect of changes in cost of capital should be timed to coincide with the rebasing of rates. The adjustments in 2007 should capture the change in ROE, the change in capital structure and the other adjustments included in the 2nd Generation IRM model. Thereafter, the annual adjustments in non-COS years should include only the changes in ROE and the incentive model adjustments. The utilities will be required to present evidence in the COS years to support any changes in the ROE and capital structure so that the Board and Intervenors can examine this in relation to first principles.

It is impractical to make interim adjustment to rates as this leads to additional costs and customer dissatisfaction. The introduction of incentive regulation and mechanical adjustment mechanisms should not add to the utilities burdens or have a negative impact on customer satisfaction.

Question 4

Disparate views exist on the efficacy of Z-factors, off-ramps, and earning sharing mechanisms, in whole or in part, to fairly mitigate company and consumer risk under IRM schemes. What possible consequences should the Board be aware of when determining the use and role of these mechanisms in 2nd Generation IRM?

Hydro One Response

The purpose of the 2nd Generation IRM is to provide a simple mechanism for adjusting distribution rates over an interim period before establishing a longer term incentive regulation model. Therefore, the general approach should be to avoid complicating the issue by not considering many of the "other" factors that are normally associated with incentive regulatory models.

The design of the 2nd Generation IRM is fairly rough and therefore there is less need for refinements that are normally associated with off-ramps and earning-sharing mechanisms. The exception is the inclusion of Z-factor which is necessary given the unpredictability of exogenous events that potentially can exert large impacts on utility costs and that typically are beyond management control.

Question 5

Are there any implementation details of 2nd Generation IRM that have not been addressed?

Hydro One Response

Given the intent of the 2nd Generation IRM is to provide a simple and mechanistic approach to adjusting rates it would be helpful if the Board were to provide an implementation step guideline that would elicit the following information:

- Outline of steps involved to obtain approval of adjusted rates
- Provide LDCs with approved source to be used in respect of the GDPPI inflator and indicate time in the year of adjustment for assuming the inflator value
- Examine the possibility of moving towards a more specific inflator for the industry during 2nd Generation IRM period and indicate timing thereof
- Confirm that Productivity (X) factor is set at 1% for the duration of the 2nd Generation IRM
- Provide timing of submission of Capital adjustment (CI) factor by those LDCs that wish to include this factor in the adjustment to their distribution rates
- Confirm that any true ups with respect to the use of CI adjustment will be done at the next COS (rate rebasing) submission by those LDCs which choose to use this adjustment mechanism
- Provide timing of submission of adjustments to ROE due to changes in interest rates
- Indicate timing of submission for approval of adjusted distribution rates
- Confirm that rate adjustment submissions will be made in written format and will not require any public review
- Confirm that approvals of adjusted rates will be automatic and identify timeline so that LDCs can plan implementation of approved rates
- Establish a cooperative industry team to support the development of 3rd Generation IRM model and develop timeline for collecting relevant information and data.